Lesson 12: Interest, Credit, and Debt

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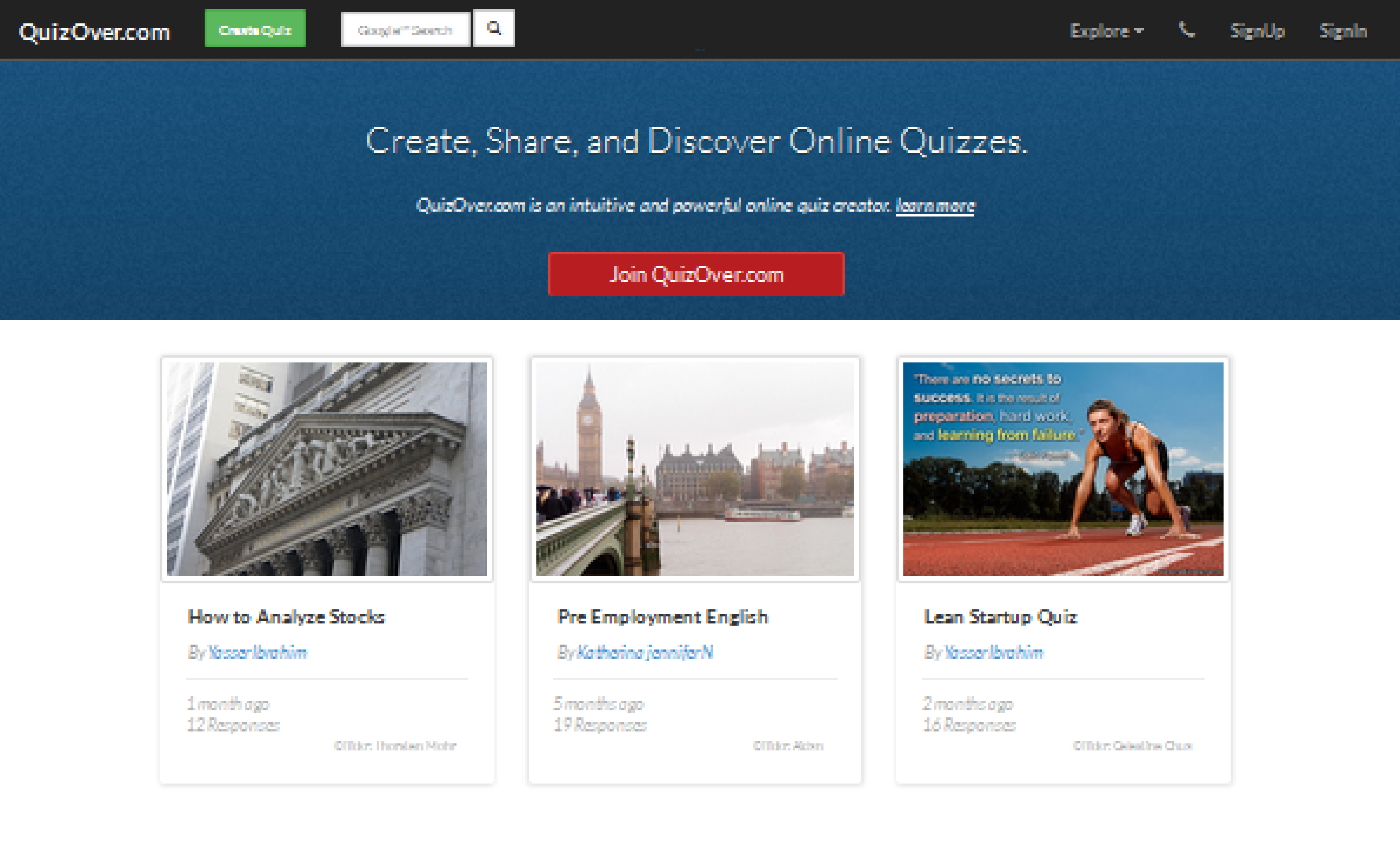

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4. Chapter: Lesson 12: Interest, Credit, and Debt

4.1.1. Why is the first section titled, "Interest: It's About Time"?

Author: Robert Murphy

Why is the first section titled, "Interest: It's About Time"?

- Interest rates coordinate the actions of savers and investors. When people postpone consumption today, it frees up resources that can begin producing the goods and services that the savers will buy in the future.

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Author: Robert Murphy

*What is the connection between interest rates and currency exchange rates?

- Interest rates allow entrepreneurs to convert money units from different years into a common denominator. Currency exchange rates allow entrepreneurs to convert money units from different countries into a common denominator.

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4.1.3. Why does a low interest rate give a "green light" to long productio...

Author: Robert Murphy

Why does a low interest rate give a "green light" to long production processes?

- Entrepreneurs must buy inputs first, then sell the output later. The lower the interest rate, the more valuable the future revenue from customers will appear in today's calculations. Therefore, a given process with fixed dollar payments for inputs in the beginning, and a fixed dollar payment by customers at the end, will appear more profitable as the interest rate gets lower and lower.

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4.1.4. What is exchanged in a credit transaction?

Author: Robert Murphy

What is exchanged in a credit transaction?

- The lender gives money in exchange for an IOU from the borrower.

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4.1.5. What is "productive debt"?

Author: Robert Murphy

What is "productive debt"?

- Debt that is used by the borrower in the hopes of increasing his or her future income.

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4.1.6. Justin forgot his lunch money at home. To make matters worse, it wa...

Author: Robert Murphy

Justin forgot his lunch money at home. To make matters worse, it was pizza day at school, and Justin loves pizza. However, his friend, Vraj,

always has money, so Justin asks if he can borrow $2.00. Vraj agrees, but insists upon being paid back $2.50 the next day. Calculate the (daily) interest rate of Vraj's loan.

- 25%.
  [50 cents in interest divided by the original amount of $2 = 25%.]

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4.1.7. Explain why the deal between Justin and Vraj was mutually beneficial.

Author: Robert Murphy

Explain why the deal between Justin and Vraj was mutually beneficial.

- Both agreed to it, so we know it was mutually beneficial. Justin got to eat his pizza, which he valued more than giving up the future 50 cents in interest, and Vraj earned the interest, which he valued more than what he otherwise could have done with his $2 the day he lent it.
  Sample Partial Credit Answer
  Both agreed to it.

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4.1.8. Other things equal, an increase in interest rates will have what ef...

Author: Robert Murphy

Other things equal, an increase in interest rates will have what effect on the quantity demanded of loans?

- People will demand fewer loans or loans of a smaller amount.

4.1.9. Identify what happens to interest rates when a community saves more...

Author: Robert Murphy

Identify what happens to interest rates when a community saves more in general, and generalize the signal that this sends to entrepreneurs.

- Interest rates tend to go down when people save more. This effectively
  signals entrepreneurs that they should borrow and invest
  more, in longer-term projects.
  Sample Partial Credit Answer
  Interest rates go down.

Check the answer of this question online at QuizOver.com:
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4.1.10. When a company sells a bond, what is it essentially doing?

Author: Robert Murphy

When a company sells a bond, what is it essentially doing?

- It is borrowing money.

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4.1.11. What is the economic benefit of a credit intermediary such as a bank?

Author: Robert Murphy

What is the economic benefit of a credit intermediary such as a bank?

- The bank matches up savers with borrowers. The bank's presence helps lower the cost of finding each other, and it makes the process safer for lenders.
  Sample Partial Credit Answer
  Businesses that need funds can borrow them from a bank.

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4.1.12. Discuss this statement: "Getting rid of all records of credit histo...

Author: Robert Murphy

Discuss this statement: "Getting rid of all records of credit histories and credit reports would help borrowers."

- Without having access to a person's past behavior, a potential lender might assume the worst and charge a high interest rate. The responsible borrowers would end up being worse off, without the ability to demonstrate their good track record.
  Sample Partial Credit Answer
  This would be bad because lenders rely on that information.

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4.1.13. Explain why the interest rates on unsecured loans tend to be higher...

Author: Robert Murphy

Explain why the interest rates on unsecured loans tend to be higher than those on secured loans.

- If the borrower defaults on a secured loan, the lender can repossess the collateral to offset the loss. If the borrower defaults on an unsecured loan, the lender has no recourse. To compensate for the added risk, a lender will charge more (other things equal) for an unsecured loan.
  Sample Partial Credit Answer
  They are riskier.